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Economic Times

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Editor's Note

Once again, our publication offers an enormously diverse assortment of articles. All of them relate in one way or another to the economy, although at first glance the connection may seem a bit strained.

Professor Olson from the University of Maryland tells us how both morals and incentives are needed in a well-functioning society. Ben Stein makes his second contribution to the publication (the first: "Power to the People" just a year ago), this time reporting on the lessons of management and economics he has learned from one of his dogs. (Yes, you'll even find the connection to economics in this one!)

Then we have two items arising from behind what we used to call the "Iron Curtain." Joshua Muravchik of the American Enterprise Institute provides some insights on how the essential concepts of democracy prevailed against great odds in the totalitarian socialist countries. And on the next page, our faithful Colloquium panel discusses the pros and cons of assisting the U.S.S.R.

The one "conventional" topic this month is the quarterly *Industry Outlook Report* in the (shaded) center section. Although the topic is conventional, the analysis is anything but.

Have a good month!



Maxim of the Month

Education: the inculcation of the incomprehensible into the indifferent by the incompetent.

John Maynard Keynes

Congrats to the Fed

Q: How is the Fed doing?

A: *Pretty well, I'd say.*

Q: Then you approve of their recent decision to lower short-term interest rates?

A: *I was thinking, rather, about the 7 percent unemployment rate.*

Q: You like 7 percent unemployment?

A: *Sure, in these circumstances.*

Q: But that's the highest rate in 5 years. The Fed's supposed to minimize unemployment, not raise it.

A: *The Fed has a gaggle of goals, not always compatible, notably the familiar inflation-vs.-unemployment trade-off. What makes 7 percent unemployment a happy number is the fact that it's not 10 percent.*

Q: Why should it be 10 percent?

A: *No reason it should be, but unemployment exceeded 10 percent in the previous cycle and touched 9 percent in the mid-'70s. So, for the worst point of the cycle, 7 percent is a good number.*

Q: I'll grant you 7 percent is better than 10 percent, but I hope you'll agree that the 5 percent unemployment we had in 1989 and early 1990 was better.

A: *Of course, but you're comparing different stages of the cycle. In fact, your argument seems to deny that the business cycle and the unemployment-inflation trade-off even exist.*

Q: No, I just think the Fed should shoot for 5 percent unemployment rather than be satisfied with 7 percent.

A: *You're asking for the moon, my friend, because 5 percent is not sustainable. That was proven again in 1989, when unemployment worked its way down to 5 per-*

cent and inflation began to accelerate gradually.

Q: That wasn't much of an inflationary outbreak.

A: *Correct, but it was enough to show the economy had been pushed too far. We demonstrated again that 6 percent unemployment is about the sustainable minimum. When the cyclical expansion pushed the unemployment rate below 6 percent, the appearance of new inflationary pressures told the Fed that it was time to apply the economic brakes and, to their credit, they did so.*

Q: I don't see why there was any hurry.

A: *The hurry was to avoid letting the gradual acceleration grow into a major surge of inflation. The worse the price disease gets, the more painful its cure. The real secret of limiting the peak in unemployment to 7 percent here in 1991 was to begin applying the monetary brakes promptly as the unemployment rate approached 5 percent. That was the Fed's triumph, the promptness of their shift to a tighter policy in 1988. A business cycle that swings no wider than from 5 percent to 7 percent unemployment is the best we can reasonably expect. And even that takes good luck, in view of the crude nature of monetary policy, the limitations of forecasting, and the tendency for outside shocks to rock the economic boat.*

Q: So you're saying we shouldn't try to do better than 6 percent unemployment?

A: *Not with monetary policy. Separately, we should try to reform the way our labor markets work, the skill mix of the labor force, and anything else we can do to improve the unemployment-inflation trade-off. But presently 6 percent unemployment looks like the most ambitious target we can maintain.*



Colloquium: Help the U.S.S.R.?

Background:

In Moscow, the agenda for discussions with the West is dominated by economics. Aid to the Soviet Union, or to its various republics, is a controversial issue, one that's sure to be with us for some time. How much aid, if any? What type? Should assistance be conditioned on economic and political reform?

Members:

Members of The Conference Board Economics Colloquium are: Stephen H. Axilrod, Vice Chairman, Nikko Securities International; Andrew F. Brimmer, President, Brimmer & Company; Don R. Conlan, President, Capital Strategy Research; Robert G. Dederick, Executive Vice President and Chief Economist, Northern Trust Company; John T. Dunlop, Lamont University Professor Emeritus, Harvard University; Lyle E. Gramley, Senior Staff Vice President & Chief Economist, Mortgage Bankers Association; Isabel V. Sawhill, Senior Fellow, The Urban Institute; Charles L. Schultze, Senior Fellow, The Brookings Institution; James Tobin, Sterling Professor Emeritus, Yale University; Laura D'Andrea Tyson, Professor of Economics, University of California, Berkeley; Charles E. Walker, Chairman, Charles E. Walker Associates; Murray Weidenbaum, Director, Center for the Study of American Business; Albert M. Wojnilower, Senior Advisor, First Boston Corporation.

Question:

In your view, should the United States and other industrial nations provide aid to the U.S.S.R. any time soon?



Robert G. Dederick
Northern Trust Company

If humanitarian aid is needed, it should be offered — no strings attached. Economic aid, by contrast, should be given only if IMF-type conditions are satisfied. What's good for others is good even for the U.S.S.R. And the best way to see that this requirement is met is to grant the U.S.S.R. full IMF membership. Forget that associate status cop-out. In any event, the amount of aid should be limited. For the most part, the Soviets should rely on their own efforts for body-building purposes. How else are they going to develop any muscles?



Andrew F. Brimmer
Brimmer & Company

Despite the erosion of central authority — and the assertion of independence by a number of Republics — economic aid should be provided to the U.S.S.R. There should be a mixture of U.S. assistance: grants of humanitarian aid, low cost food shipments, Export-Import Bank loan guarantees, support for full membership in the IMF and World Bank, relaxation of most restraints on exports of industrial technology, extension of most-favored-nation trade status, and full insurance of direct investment by U.S. firms.



Murray Weidenbaum
Center for the Study of
American Business

Should the U.S. provide financial support to the Soviet Union while they continue to build nuclear submarines and other weapon systems? That's ludicrous. To achieve political and economic freedom, the Soviets will have to earn it on their own. We can't bribe them to do it. They grow enough food; they have to learn how to distribute it before it spoils. At most, we should send technical experts to teach them the rudiments of capitalism.



Charles E. Walker
Charles E. Walker Associates

Humanitarian and technical aid? Yes, as soon as logistics allow. Economic aid? Only after an irreversible reform program is on track — one that significantly demilitarizes the Soviet Union and establishes a market economy through extensive privatization, a workable price system, and a convertible ruble. This will ultimately attract the private investment that is the key to growth. Official aid, except for humanitarian purposes, should only be complementary to and supportive of private investment.

Morals, Incentives, and Effective Democracy

by Mancur Olson



To work well, a society requires not only widespread adherence to appropriate moral codes, but also an appropriate structure of incentives. A good structure of incentives gives the individuals in a society a reason, given individual self-interest, to behave in ways that improve the quality of life. In other words, I think of morals and incentives not as opposites or enemies but rather as indispensable partners, both of which are needed if we are to have a well-functioning society. We also need the right division of labor between the partners: we must note the circumstances in which reliance on morals, on the one hand, or on incentives, on the other, will be most suitable.

The problem begins with the fact that *morality is a scarce resource*. Even after millennia of preaching, morality is still in short supply. I am not suggesting that moral behavior is rare or characteristic of only a few saintly types. Some amount of moral behavior seems to me to be general in every society.

Suppose you are lost. If you ask for directions, in the overwhelming preponderance of cases, you get them, and you get them for free. Now that's a banal observation, but it nonetheless tells you that the willingness to help others (some degree of altruism) is virtually universal. Similarly, when there is an accident — when someone is bleeding profusely or there is a heart attack — people nearby will almost always help.

So I treat moral impulses as general characteristics of the population, not as something that is exceptional.

Yet when it comes to getting society's hard work done on a day-in-day-out basis, it generally appears that morals alone are not enough. Take nations during wars, especially wars where there is a consensus in the population that the nation is right and that it ought to win the war. Even in these circumstances, altruistic impulses are not sufficient to finance the war effort. Every country in these circumstances needs taxes to finance its war effort. Thus there can be no doubt that societies need to use incentives.

One well-known way in which incentives are used to get the world's work done is, of course, through competitive markets, a concept that goes back all the way to Adam Smith. Almost everyone realizes that in certain circumstances markets can function effectively for a society. We all know that there are a variety of market economies, like our own, with reasonable economic performance, and now everyone knows of the economic failures of Soviet-type societies. Thus the idea that the market can harness the self-interest of people to generate desirable social outcomes is one of which most educated people are already aware.

I would like to focus here on the role of incentives, not in private markets but in government and politics. I believe we can get some ideas on how to make our own society and government work better, if we look at the emergence of law and order and government.

Let's ask: How does a peaceful order emerge, how does a government emerge, where there is initial anarchy? My thinking about these questions developed when, by chance, I was reading the biography of a Chinese warlord named Feng. There was a struggle between this war-

lord's army and a similar-sized army of a roving bandit. The warlord's army won and Feng became famous and popular.

When I read that I thought, "how arbitrary!" What legitimacy does a warlord have? A warlord is nothing but a *stationary* bandit, and thus morally no better than a *roving* bandit. By what moral principle do we prefer a warlord who does his banditry on a fixed location with taxes rather than by roving around?

But suppose we ask how ordinary people would fare when there are just roving bandits, as compared with the situation when there are stationary warlords who defeat the roving bandits and engage in tax-theft instead. The roving bandit takes what he finds and moves on. But the stationary warlord has an incentive to get as much tax revenues as he possibly can. But how can he get the most tax revenue?

He will get the maximum in tax theft only if the domain that he has conquered is productive. The more income that is generated in his domain, the more he can collect in taxes. A good stationary bandit will make sure that there are incentives to produce; he will, in other words, provide a peaceful order (including order with respect to tradeables, which we call "property rights"). With law and order there will be a great increase in production. People will believe, if they expect law and order to continue, that if they produce something they will be able to keep that part of it which does not go into tax revenue. They will, moreover, have incentives to invest, because law and order will mean that they will be able to keep the goods and machines that they have invested in. The stationary bandit or warlord has an incentive not to allow

anyone else to steal because that will mean less for him, so apart from his taxes there is no other theft allowed.

In short, a bandit will maximize his receipts from thievery if he settles down, appoints himself King, provides government, and takes all his theft in the form of predictable taxes. By contrast, if his armed force instead is used for roving banditry then there will be very little production. People will only produce things that they can hide or consume promptly. There will be a very low level of output indeed, and this will even generate problems for the roving bandits. In anarchy there is not much for roving bandits to steal.

Thus I am suggesting that the beginning of ancient or classical civilization was probably, in many cases, the result of the incentive that conquerors had to set themselves up in the business of government, because what they could get in theft through tax collection was greater than what they could get by migratory pillage. Law and order, then, was something there was sometimes an *incentive* for a conqueror to provide. *The first blessing of the invisible hand was government!* The invisible hand led the conqueror to provide domestic order and other public goods because this made his take larger.

Given my own democratic sensibilities the foregoing argument is troubling. I had to ask myself, "Is it possible that, contrary to what I have always believed, dictatorship is better than democracy, because the dictator will have an incentive to make the society work?"

But one of the things that we observe is that kings and warlords use a large part of their revenue for wars for their personal aggrandizement. Kings maximize their tax collections for the purpose of war as well as for palaces. Even though the king is trying to make the society work, he is trying to make it work so that he can milk the maximum amount out of it. Needless to say, that is not the sort of thing that is best for the subjects. It's better than being a victim

of roving bandits, but it is hardly the best sort of situation.

Application to Democracy

Now let us look at the incentives facing a President in a system like ours, or a well disciplined political party in a two party system. If a President wants to get re-elected, then what kinds of policies will he have an incentive to adopt? Will his incentive be like the dictator's incentive to maximize tax collections? Surely not. The best way to get re-elected is to persuade at least a majority of the electorate that their welfare will be higher if they re-elect the existing President or political party.

The welfare of the electorate depends on the *net* benefit of the government's actions for the citizenry. If a President or party succeeds in making the country work well, and succeeds in making it work in the interest of the electorate (or at least the majority of the electorate), then he will have a better chance of getting re-elected by this electorate. Thus the President will, of course, collect taxes, but he has an incentive to impose a level of taxes and public expenditure that serve the interest of at least a majority of the citizenry.

Now one of the things that happens in our democracy is that organized groups find it in their interest to lobby or to collude and cartelize in ways which are good for them but bad for the country. So I'm not saying the simple model that I just described does justice to the current American scene, or for that matter to any other country.

But the simple model does, nonetheless, tell us something. And that is that when we introduce democratic procedures there are officials or parties that can be held responsible for how well the society is working — for *outcomes*. When democratic institutions are structured so that it is clear who is in charge, then those who are in charge can be held responsible and the outcomes for the country can be attributed, in part, to the government or misgovernment of the official or party in charge. When we have that situation, we have a party or official with an incentive

to behave in such a way that the welfare of the citizenry — or at least a majority of the citizenry — is taken into account.

Accordingly, even in the realm of government (not only in the marketplace) it pays to think about how to improve the structure of incentives. Though the foregoing account of two-party democracy is oversimplified, it is sufficient to suggest that our country would work somewhat better if there were more party discipline in the Congress. Then the parties would have more of an incentive to make a country work than do individual congressmen, or than the special interests from whom the congressmen get their campaign contributions. We can see, in other words, the benefit of strengthening our political parties. That is desirable because it gives politicians a reason, in their own self-interest, to make the society work better.

I wouldn't want to push the argument that I have made too far. I don't believe it is within the wit of man to work out a society where *everyone always* has a compelling interest to act in a way that is ideal from the point of view of the society. Go back to my trivial example about getting directions for free. It tells us that no matter how much we worked at it, we couldn't set up a market which would work so well that people would *efficiently* get directions for pay!

There are many circumstances, in government and outside of government, where even with the best knowledge in the world we can't put forth a perfect structure of incentives. So there is still plenty of work left over for morality, even after we improve the structure of incentives. Indeed there is so much work left over for morality that we should structure incentives so that we do not need to call on morality any more than we have to.

Excerpted from "The Role of Morals and Incentives in Society" in Joseph E. Earley, Editor, *Individuality and Cooperative Action*, 1991, Georgetown University Press, Washington, D.C. Mancur Olson is Distinguished Professor of Economics at the University of Maryland at College Park. He also chairs the Center on Institutional Reform and the Informal Sector funded by the U.S. Agency for International Development.

Trixie's Principles of Management and Economics

by Benjamin J. Stein



I have seen them come and go. The top dogs of finance and manufacturing and construction, and written about many of them. Some of them, like Sam Walton, came from virtually nothing and built great empires based in part on understanding management. Others, like Charles Keating, Jr., built empires of finance and real estate built upon the sand of fraud. They vanished like Ozymandias because their understanding of management was flawed and fraudulent.

But in terms of managing effectively, coming from nowhere to complete success, and accomplishing prodigies with virtually no financial or educational capital, no manager I have ever seen is in a class with my German short-haired pointer, Trixie. From absolutely nothing, from being an abandoned dog at a kennel for abandoned dogs, with no money, no family connections, no Harvard education or Yale degree, Trixie has gone on to accomplish complete dog success.

She has a loving home, a master who virtually never leaves her side, cradle to grave (which I hope never comes) medical, housing, and nutritional care, and the undying love of everyone who meets her. In dog terms, her security is vastly greater than what any human could expect to achieve even if he were a billionaire. A billionaire, after all, could lose it in a real estate crash, could be indicted for securities law violations, or could get nailed in a divorce. Trixie is secure, and is provided for by other members of my family should I be terminated with extreme prejudice before her. She does not even know the words "grand jury."

How did Trixie do it? What were her management secrets and techniques? As far as I can tell, she had only a few, but she knew them well and lived by them:

1. She knew her goals. She wanted to be loved, fed, walked, kept dry and warm. She did not waste time on fame, fast cars, or women (not to mention wine and song). In this way, she conserved her energy.

2. She rapidly learned who fed her. Within hours of her arrival, she observed that yours truly dispensed the food.

3. She was kind to the hand that fed her. Trixie could not pay for her food, of course, but she could observe that I liked having her be devoted to me and follow me around. She had no cash, but she did have an unlimited capital of devotion. She paid me with that vastly beyond the money value of the dog food I gave her. (As an economist might say, she capitalized on her comparative advantage. She had an abundance of low-cost devotion, while I had an abundance of low-cost food. We traded for our mutual advantage. This is something basic, which few managers indeed know.)

4. She kept out rivals and thereby enjoyed a price-fixed market in my affection and was able to realize monopoly rent or rewards far beyond their market rate or cost of production. By virtue of biting our three other dogs if they came too near to me or seemed to be staking a claim to my affection, and even threatening humans who came close to me, Trixie ensured that she did not have her price lowered to what the average dog would take to be a devoted companion. She kept out rivals with her teeth and her claws, and was able thereby to realize far more attention, food, and exercise than if the other three dogs had been permitted to get close to me.

5. She understood that silence was preferable to argument with the hand that fed her. When she was faced with an unattractive situation, such as being left at home when she did not want to, she did not

whine or complain. She simply looked sad, and then went to sleep. That is, she made me feel guilty and eager to appease her instead of threatening me and making me angry. In this way, she further raised her price and value to me, and raised her own income.

The analogy for a human manager would be that if his boss told him to do something he did not want to do, he should look sad, but go about it without argument. This, some might say, is not dignified, and that's true. But on the other hand, collecting added rewards from your boss is dignified — and how much good has arguing with your boss ever done you, anyway?

6. She understood instinctively that looking the part was crucial to success. Trixie is a thoroughbred brown and white German short-haired pointer. She is almost unbelievably good looking. When I walk her, passers-by in cars whistle at her (certainly not at me). Moreover, she looks like a dog. She looks like a Ralph Lauren dog, a prototypical dog, from an English hunting lodge, held by a Mountbatten on a leash.

Obviously, she had nothing to do with that, but she has used it to great advantage. She knows — or at least benefits from — the principle that people like what's pretty more than what's not. They also like what looks like what it's supposed to look like. Trixie knows — or at least benefits from — the principle that appearance means a lot.

That's it. That's how Trixie went from nothing to dog management triumph. She's sleeping under the covers in my bed right now while I'm working, by the way, but you probably already knew that. That's success, after all. That's dog management brilliance.

Benjamin J. Stein is author of *Hollywood Days*, *Hollywood Nights: Diary of a Mad Screenwriter*.

Overview: Recovery and Competition



Edgar R. Fiedler
The Conference
Board

The mood of the industry specialists in this Report encompasses a broad range of expectations from pessimistic to careful cheerfulness. The closest to a sour note is steel, where total deliveries are forecast to hold steady from this year to next, and profits may decline.

The strongest auguries are reported for paper and electronics, where sales and earnings are expected to bounce back sharply in 1992. Business services will see continued increases in demand. In the chemical industry, prospects are more subdued, with modest growth expected but prices remaining depressed.

In the farm community, the outlook is mixed, with grain prices most dependent upon how much food aid and export credits are made available to the U.S.S.R. For the American consumer the most encouraging forecast is that food prices, which advanced 5.8 percent in both 1989 and 1990, will only rise 2-4 percent this year with the slower pace of advance continuing into 1992.

The intensity of competition, especially global competition, is a recurring theme in this Report. Its impact was cited by the majority of our experts — most notably, perhaps, for business services — and was implicit in the others' analyses.

Our oil analyst, Kathy Cooper, concludes her outlook by wondering whether 1992 will produce another "August surprise," like the Gulf war of 1990 and the attempted coup in the Soviet Union this year. Shocks of that sort are, of course, possible at any time. Absent such events, however, our panel is moderately optimistic about the outlook for 1992. They anticipate, on balance, a steady expansion of economic activity in an environment of strong competition.

Electronics: Stronger Growth in 1992



Vladi Catto
Texas Instruments

The U.S. electronics market has been sluggish for the past 18 months, with weakness in computers, automotive and defense electronics offsetting moderate growth in communication, industrial and consumer electronics. Electronics shipments did rebound weakly in July, up 1 percent over June levels, and have now increased in three of the past four months. But this recent improvement will not be sufficient to raise total shipments for 1991 significantly above the 1990 level.

The semiconductor industry, feeding components into electronic end-equipment, continues its moderate recovery from a weak 1990 performance. Demand is benefiting from the rapidly increasing semiconductor content of electronics

products. Through this year's second quarter, semiconductor shipments were 6 percent above year-ago levels.

The U.S. electronics industry is likely to experience stronger growth in 1992 for a variety of economic and technological reasons: The business cycle recovery, now under way, will be moderate but durable. Overseas, the Asia/Pacific region continues to defy gravity with several countries expected to see GNP growth in the 7-9 percent range. Japan still advancing at a healthy if slower pace, and Europe likely to survive 1991 without a broad recession. Electronic equipment inventories remain at historically low levels. The current pricing environment in the electronics industry is more stable than in 1990. Software development is be-

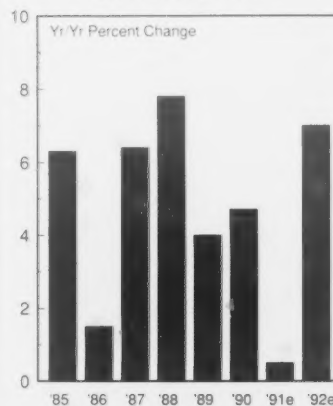
U.S. Electronics (percent change)

	Shipments	Profits
1990	4.7	-4.6
1991	0.5	-4.0
1992	7.0	+30.0

ginning to catch up with the hardware, which will exercise a beneficial pull-through effect on computer sales.

Despite current uncertainties, long-term prospects for the electronics industry are still very positive. We are a long way from reaching the limits of technology. With advances in semiconductors leading the way, electronics will advance from the fifth largest industry in the world today to number one in the next century.

U.S. Electronics



Petroleum: Adequate World Capacity



Kathleen B. Cooper
Exxon

This year's "August surprise" barely ruffled world petroleum markets, but the failed coup in the Soviet Union has not erased concerns about Soviet oil production. Because of outdated technology and management problems, output in the world's largest oil-producing nation has dropped by roughly two million barrels per day since 1988 (equivalent to the loss of another Kuwait). Soviet demand has also fallen, resulting in an export decline of around one million barrels per day. New political arrangements and economic reform must still be sorted out by the republics and the central government if the production decline is to

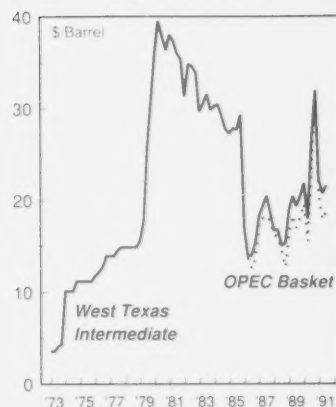
be reversed. Furthermore, civil unrest and inter-regional hostilities that disrupt oil exports cannot be ruled out.

The aftermath of the Gulf war — 1990's August surprise — continues to create uncertainty. Iraq is still considering whether to accept the U.N.'s conditions for emergency oil sales (that could lead to roughly 500,000 barrels per day for six months). Fire-fighting in Kuwaiti oil fields is proceeding apace, but exports of more than 400,000 to 500,000 barrels per day by year-end are questionable.

Since the liberation of Kuwait, the OPEC Basket price has remained significantly below OPEC's \$21 target. In the absence of Iraqi exports, world demand during the coming winter would bring world oil markets into balance with little spare capacity and could firm prices toward their target. Inventories and surge production capability, however, appear adequate to provide a buffer for a cold winter.

In 1992, the U.S. and Europe's economies should pick up steam, with world oil demand rising accordingly. Uncer-

Crude Oil Prices



tainty remains about Soviet production and exports. The real issue, though, will be OPEC's response to growing Kuwaiti and possibly Iraqi exports when demand declines seasonally next spring and summer. On balance, world capacity should be more than adequate in 1992 ... unless, of course, there is another August surprise!

Steel: Another Year of Profit Declines?



Peter F. Marcus
PaineWebber, Inc.

Shipments by domestic steel mills in 1991 are forecast at about 77 million tons, down from 85 million tons the year before. While steel demand is down about 7 percent, shipments have been helped by rising exports and lower imports. Users appear to have liquidated inventories to a lesser extent than in prior recessionary periods. A key positive for the steel

companies has been a sharp pick-up in orders in the June-August period after four extremely low months. Prices of spot flat-rolled steel for fourth quarter delivery have risen about 3-4 percent recently.

The consensus calls for domestic deliveries to rise to about 80 million tons in 1992. For our part, we think shipments may remain flat at 77 million tons. We do not see a sharp recovery of steel demand because the domestic capital equipment cycle has stagnated (reflecting pressures on industrial companies' profits) and no sizable snap-back seems possible in the private construction sector. Also, reflecting the sharp decline of world steel spot export prices in recent months, steel imports in 1992 may rise from 16 to 18 million tons, with exports down from 6 to 4 million tons. Hence, granted that steel consumption rises from 87 to 90 million

tons and that steel users do not change their inventories, this works out to domestic deliveries in 1992 of only about 77 million tons.

An important issue confronting major domestic steelmakers is their ability to sustain profits when the operating rate is only fair (as expected in 1992). The industry has become increasingly global. New technologies are revolutionizing the industry. Currently, there are 29 producers of flat-rolled steel in the United States and Canada. Many foreign mills are also vying for this market. Furthermore, Nucor, the country's leading minimill, has built an 0.8-million-ton-per-year thin-slab/flat-rolling mill in Indiana and has a second 1.0-mtpy facility under construction in Arkansas. 1992 could be another year of profit declines in the steel sector.

Agriculture: Slower Food Price Increases



Robert L. Thompson
Purdue University

Weather, here and abroad, is the dominant factor in the outlook for agricultural markets. Drought, especially severe in the eastern Corn Belt, dropped 1991 U.S. corn production by a projected 8 percent, and soybeans by 5 percent, relative to 1990. Similarly, poor growing conditions in the USSR have cut their grain crop by an estimated one-third to 190 million metric tons in 1991.

The reduced U.S. inventories of grain together with the short Soviet crop are the two key factors that will dominate grain markets into 1992. The key to how much prices strengthen will be the magnitude of food aid or export credits made available to the Soviet Union.

In other farm sectors, the 1991 U.S. cotton crop is projected to be the largest since 1937, and sugar output may set a new record.

After several years of record livestock receipts, large inventories of beef cattle and hogs moving to markets have significantly reduced meat prices in 1991.

Net income of American farmers in 1991 is likely to fall about 10 percent from the 1990 record, and will likely be the lowest since 1986. The principal causes of this drop are lower livestock and milk prices and the smaller grain production. The drop in farm income is

causing an increase in farm financial stress relative to the last several years, especially in the eastern Corn Belt.

The implications for the farm input industries are mixed. Farmers will probably be required to set aside less farm land in 1992, and the resulting increase in area planted will stimulate purchases of seed, fertilizer, farm chemicals, and energy. On the other hand, the weakened financial position of many farmers is likely to depress sales of farm equipment.

With lower meat prices leading the way, the increase in food prices in 1991 should be only 2-4 percent, down from 5.8 percent in both 1989 and 1990. This slower rate of increase in food prices should continue well into 1992, at least until the next crop can be predicted with some accuracy.

Paper: Recovery Ahead



John Chrysikopoulos
Goldman Sachs

Demand for paper products is primarily influenced by economic conditions. During the first half of 1991, demand declined for virtually every product category, but now it appears that this trend is reversing, albeit at a very modest pace. The industry has, therefore, passed the low point of the demand cycle, and a recovery, expected to become apparent before year end, should last for the next two years or so.

Industry operating rates, the key to prices and profits, are expected to remain depressed through 1992, given the significant capacity additions currently under way coupled with an environment of below-trend economic (and paper-demand) recovery. As de-

tailed in the first table, a meaningful improvement in operating rates for the key paper product lines is not expected until 1993. More important, the level of operating rates through 1993 is forecast below the average of the last ten years.

Selling prices for key product lines are expected to improve in advance of the operating rates due to a turnaround in market psychology, driven by expectations of continued stronger demand conditions, inventory accumulations, and the absence of any major new machine startups. New capacity tends to depress selling prices prior to startup as companies try to pre-sell the output. The improvement in selling prices is forecast as early as the fourth quarter. Over the

next two years, industry sales and earnings are expected to improve dramatically from the very depressed 1991 levels (second table), primarily due to higher selling prices and volumes and lower costs resulting from more efficient machines and higher operating rates.

Paper Industry Operating Rates (percent)

	1980-90 Average	1991E	1992E	1993E
Newsprint	93.2	88.6	88.9	91.9
Uncoated free sheet	92.5	87.9	86.5	90.4
Coated	92.6	86.6	87.9	90.0
Tissue	92.9	96.8	96.3	96.0
Linerboard	94.5	93.4	92.6	94.1
Bleached paperboard	92.9	93.4	93.5	92.8

Paper Industry Sales and Earnings

(percent changes, year over year)

	Sales	Earnings
1990	20.4	-34.2
1991E	-2.8	-43.9
1992E	9.5	80.3
1993E	5.6	40.0

Chemical Industry: Lackluster Recovery



Robert S. Reitzes
C. J. Lawrence

The recovery in the chemical industry has been lackluster this year. Sales are only 3.3 percent above a year ago and profits have declined for most companies. Over the next 6-9 months the outlook is for continued modest growth but with pricing depressed.

Wholesale chemical prices remain weak, dropping 3.8 percent in July and in six of the past seven months. Prices have declined as a result of new capacity, a run-down of inventories, a decline in raw

material prices and weakness in the economy. With only a modest economic pick-up expected, it is doubtful that prices will rise significantly. Prices appear to be close to their cyclical lows, however. For example, polyethylene, chlorine, and styrene prices are close to historic lows. On the positive side, inventories declined in July for the fourth straight month and appear to be at extremely low levels.

To improve profits, several large chemical companies have undertaken significant restructuring programs — Du Pont, Monsanto Company, and Imperial Chemical Industries. These companies are not waiting for the recovery but have decided to lay off large numbers of employees and sell off or shut down poor operations. In addition, most companies have completed large-scale capital spending programs to increase capacity, improve productivity, and reduce environmental concerns.

Going forward, chemical companies that purchase raw materials such as propylene and ethylene will benefit from the decline in materials prices. In addition, lower interest rates should contribute to a gradual improvement in housing and autos — two of the most important customers of the chemical industry. The fiber industry has already turned around, while the paint industry is also improving. Plastics and industrial chemicals are lackluster.

Chemical earnings are expected to pick up next year as the economy recovers and restructuring efforts take hold. For the non-commodity companies, earnings could be up by 15 percent — accelerating in the second half of next year. For the commodity producers, because pricing deteriorated throughout most of the second and third quarters of this year, earnings will be flat to down.

Business Services: Still Growing



Michael P. Niemira
Mitsubishi Bank

Business services, still one of the fastest growing sectors of the economy, are a highly diverse industry. It is useful to think of business services as being composed of two distinct segments: *business support services*, including advertising, credit reporting, and data processing, and *infrastructure support services*, which include temporary help companies, mailing and reproduction services, and building maintenance. Between 1973 and mid-1991, employment in business support services grew by an average of 7.5 percent per year. Business infrastructure services employment also expanded by a remarkably strong 8.0 percent pace. This growth, which was stimulated by more

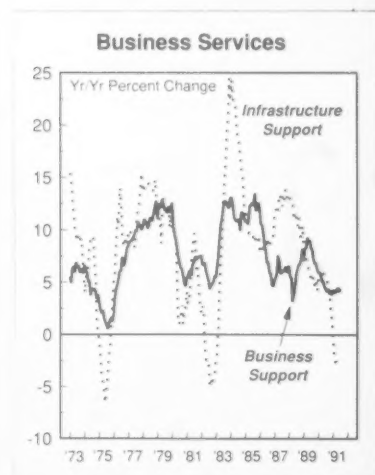
Business Services (Percent change)		
	Output	Profits
1988	12.2	6.6
1989	10.3	7.4
1990E	7.7	6.9
1991E	5.0	5.4
1992E	9.2	8.2
1993E	9.1	9.4

and more companies jettisoning some of their support operations, preferring instead to purchase those services, took place at a rate about four times faster than the growth of the total U.S. workforce.

Over the next year, temporary help companies, about one third of the industry, should experience a healthy rebound in business. Two factors will help propel their growth: First, demand from companies that experience a "work overload" situation as the economy picks up momentum and, second, the greater use of temporary help by the Federal government, which now is a small part of the demand for that business.

International competition for business services is heating up. Advertising, public

relations, and management-information-systems firms are mounting a major international push to secure 1992 European Community contracts. The risks and rewards are great and the competition with Japanese and European companies is intense. Ultimately, the trend toward more professional specialized services is likely to continue and result in significant growth of the business services industry.



The Potency of Ideas

by Joshua Muravchik



America has won the cold war — almost without trying — and there is an important lesson in this: the potency of ideas in international politics. Ironically, we Americans, who possess a profound and successful idea, have rarely understood the potency of ideas, while the Communists, who possess a false and failed idea, have understood it quite thoroughly. Thus, during most of the cold war, even dealing from a weaker hand, they outdid us in the realm of political competition, merely by working at it so much harder. What little Americans know about ideological combat we learned in reacting to the Communists. Yet despite our ineptness, the democratic idea proved enormously powerful.

As Communist regimes tumbled in Eastern Europe, Americans were surprised to see the depth of yearning for democracy and the degree to which people understood at least the essential outlines of the democratic idea. When East Germans took to the streets of Leipzig, Czechs to the streets of Prague, or even Romanians to the streets of Bucharest, they were strikingly clear in their demands. They asked not for a true press but a free press, not for enlightened rulers but for free elections, not for a reformed party but a multi-party system. They homed in on the essence of democracy despite the confusion that their rulers attempted to sow about the meaning of "democracy," an effort that seems to have borne more fruit among Western academics and publicists than among East European subjects.

And now that we have seen how firmly East Europeans grasped the concept of democracy, we often hear that the Chinese students who gathered in Tiananmen Square to demand democracy did not really understand the meaning of the term. Perhaps not. But it is striking that they chose to model their goddess of democracy in the shape of the Statue of Liberty.

The death throes of communism mark the beginning of the twenty-first century. It may be the American century. Henry Luce once said that the twentieth century would be the American century. But in fact it is better recognized as the totalitarian century. The various totalitarian systems now all seem to be ending in failure, but while they lived, they called the action. America emerged victorious over them all, but each of those victories came in defense.

If, however, we can advance the spread of democracy, perhaps not everywhere but at least to the majority of mankind, then the twenty-first will be the true American century. This will come about not by the spread of American power or by the exact imitation of American institutions but by the spread of those profound and humane ideals on which America was founded.

Excerpted from a summary of *Exporting Democracy: Fulfilling America's Destiny*, by Joshua Muravchik, The AEI Press, Washington, D.C., 1991. Dr. Muravchik is resident scholar at the American Enterprise Institute.

Problems of Economic Conversion

(An illustrative story from Russia, surely apocryphal)



ASoviet factory that had produced missiles under the old regime converted to the production of wheelbarrows. Because the factory was capable of doing first-quality work and was accustomed to dealing with high-tech metals, it decided to make the barrows out of vanadium. Technologically, the implement proved to be a great success; it will probably last a thousand years. But excessive material costs made the wheelbarrow a complete failure economically.

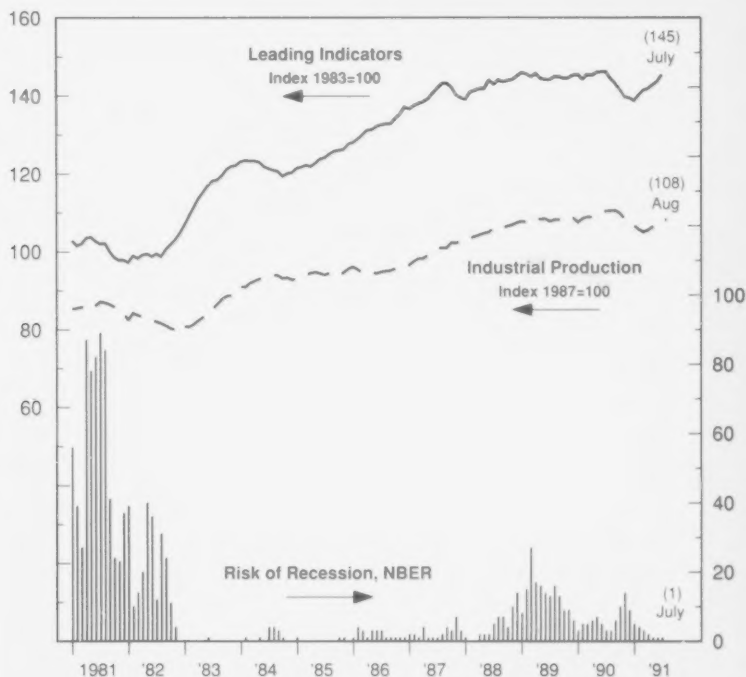
Conference Board Stat File

Classic Business Cycle

The U.S. business cycle continues to track a classical recession-recovery pattern. The contraction ended in April or May and the recovery — contrary to the anxiety heard so often these days — promises to continue into and through 1992. Where will the increases in demand come from? Inventory rebuilding and exports, notably, with consumer spending, capital investment and single-family housing contributing as well. Large-scale construction will be a drag. The pace of recovery is problematical, but the guess here is near the high end of the range found on our "Crystal Ball" page. Inflation is easing toward 4 percent. All in all, not an unhappy outlook. (Note: Data for Conference Board series in this section are available upon request from Ken Goldstein at 212-339-0331.)

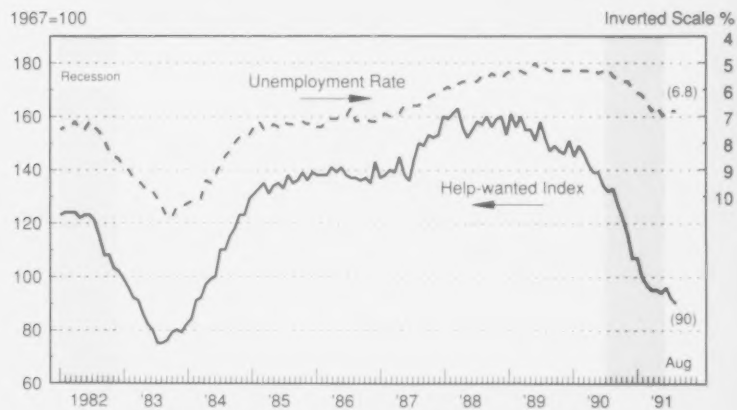
Early Warning Indicators

Classical cyclical recovery continues.



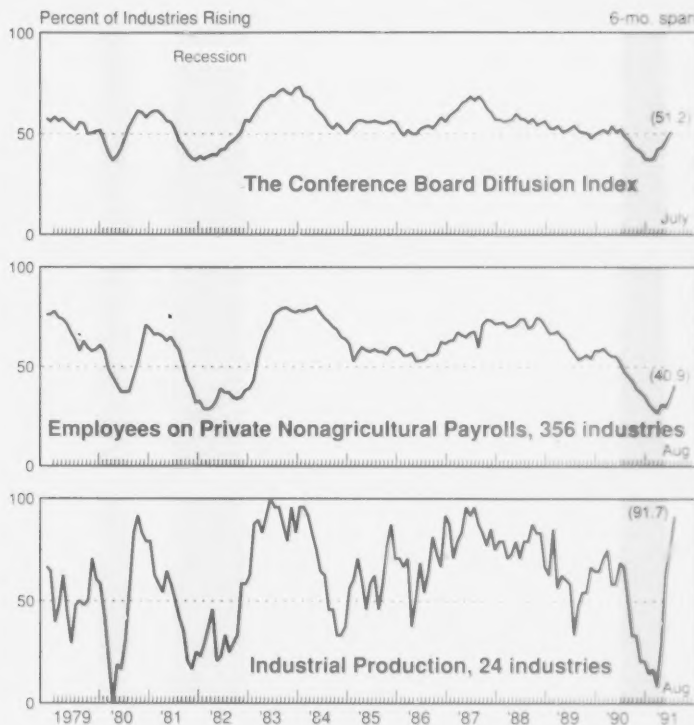
Help-wanted Advertising and Unemployment

No pick-up yet.



Conference Board Stat File

Indexes of Economic Momentum



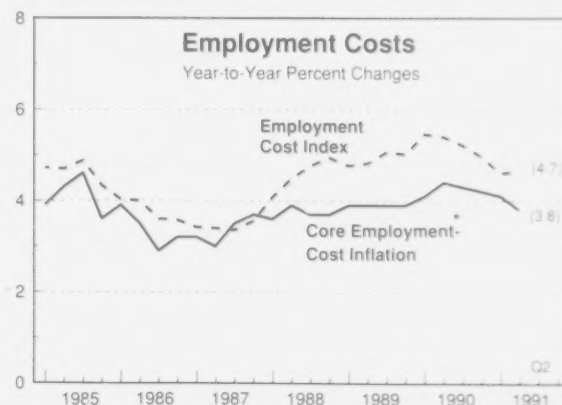
Momentum strengthens further.

Slowing of inflation now fully evident.

Inflation Fundamentals



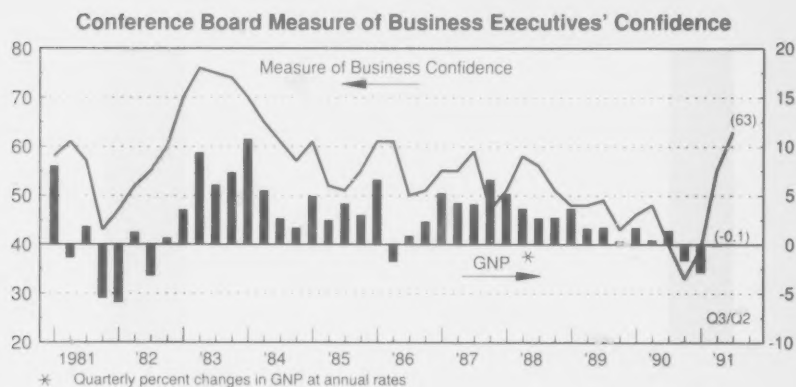
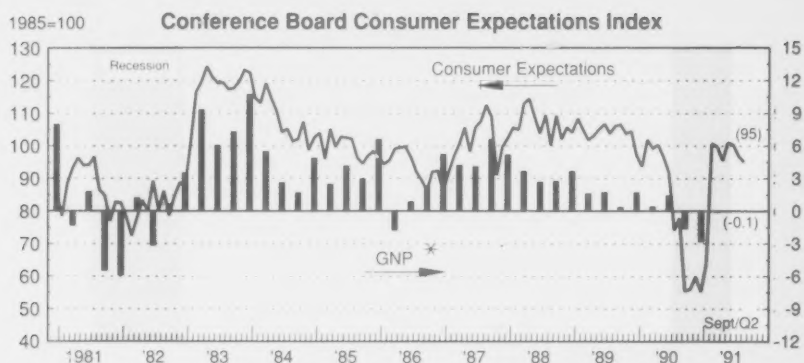
* Core Inflation = CPI excluding food at home and energy.



* Core employment-cost inflation = wages and salaries of private sector workers excluding sales personnel (i.e., excluding the benefits that are part of the ECI).

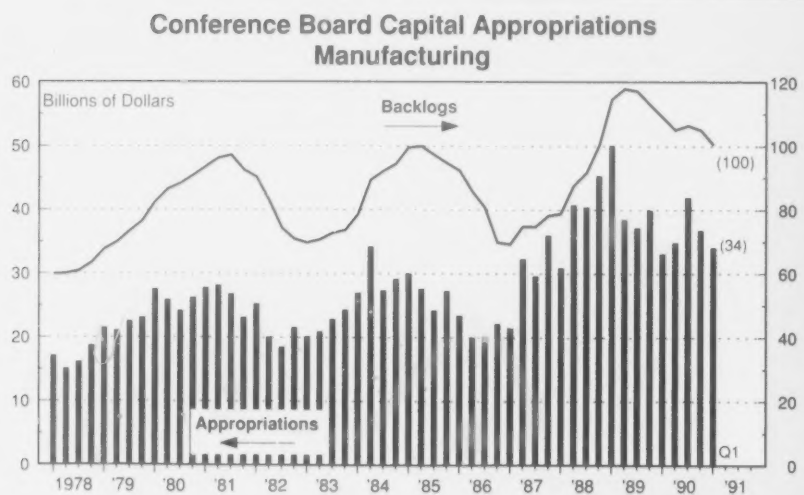
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Confidence



Both measures at recovery levels but not ebullient.

Investment Intentions



Export strength limits recession weakness.

Inside the Crystal Ball

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MERRILL L.
DU PONT
GEORGIA ST.
NORTHERN TRUST
CONF. BOARD
EATON
L.H. MEYER
DRI
WEFA
MICHIGAN - RSQE

Date of Forecast Sept. Sept. Sept. Sept. Sept. Sept. Sept. Sept. Sept. Sept.

Gross National Product

(Quarter-quarter percent change, constant dollars, seasonally adjusted at annual rates)

		%	%	%	%	%	%	%	%	%	%	%		
Actual	1991 1Q	-2.8	-2.8	-2.8	-2.8	-2.8	-2.8	-2.8	-2.8	-2.8	-2.8	-2.8	1Q 1991	Actual
	2Q	-0.1	-0.1	-0.1	-0.2	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	2Q	
Forecast	3Q	2.0	3.7	2.7	2.2	3.6	2.7	3.7	3.1	3.4	2.6	2.9	3Q	Forecast
	4Q	3.6	3.4	2.7	2.9	3.4	2.6	3.9	2.2	2.6	4.4	3.6	4Q	
	1992 1Q	4.6	2.9	3.0	2.4	3.3	2.5	4.1	2.8	3.8	3.8	3.0	1Q 1992	
	2Q	4.2	2.6	3.3	2.3	3.4	1.9	3.3	3.1	3.3	4.2	2.6	2Q	
	3Q	3.3	2.3	3.4	2.7	3.2	2.3	2.4	3.5	2.2	3.5	2.4	3Q	
	4Q	1.9	2.0	3.3	2.5	3.0	2.3	3.0	2.5	2.2	2.6	1.9	4Q	
	1993 1Q	1.8		2.9			1.9	3.9	3.2	3.3	2.3	1.8	1Q 1993	
	2Q	1.6		2.9			1.9	2.7	2.6	3.1	2.6	2.0	2Q	
	3Q	3.0		2.7			2.0	1.8	3.1	3.1	3.0	2.1	3Q	

Inflation (GNP Deflator)

(Percent change from same quarter one year earlier)

Actual	1990 4Q	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	1990 4Q	Actual
Forecast	1991 4Q	3.4	4.1	4.1	4.3	4.4	3.6	3.7	4.0	3.6	3.0	3.8	1991 4Q	Forecast
	1992 4Q	3.0	3.9	3.6	3.7	4.0	4.1	2.3	2.7	2.7	3.0	3.5	1992 4Q	

30-Yr Treasury Bond Rate

(Percent per annum, quarterly)

Actual	1991 1Q	8.2	8.2	8.2	8.2	8.2	8.2	8.2	8.2	8.2	8.2	8.2	1Q 1991	Actual
	2Q	8.3	8.3	8.3	8.3	8.3	8.3	8.3	8.3	8.3	8.3	8.3	2Q	
Forecast	3Q	8.4	8.3	8.2	8.2	8.2	8.2	8.2	8.2	8.2	8.2	8.4	3Q	Forecast
	4Q	8.5	8.3	7.8	8.0	7.9	8.0	8.2	7.8	8.1	8.1	8.3	4Q	
	1992 1Q	8.6	8.1	7.9	8.1	7.9	7.9	8.4	7.7	8.3	8.2	8.4	1Q 1992	
	2Q	8.7	8.4	8.0	8.3	8.0	7.9	8.4	7.6	8.4	8.3	8.4	2Q	
	3Q	8.7	8.3	8.0	8.4	8.1	8.1	8.4	7.6	8.1	8.3	8.3	3Q	
	4Q	8.8	8.3	8.0	8.6	8.2	8.2	8.5	7.5	7.9	8.4	8.2	4Q	
	1993 1Q	8.9		8.0		8.3	8.3	8.5	7.4	8.0	8.5	8.1	1Q 1993	
	2Q	8.9		8.0		8.4	8.4	8.4	7.3	8.0	8.6	8.1	2Q	
	3Q	8.9		8.1			8.5	8.4	7.2	8.1	8.7	8.2	3Q	

Unemployment Rate

(Percent, quarterly)

Actual	1991 1Q	6.5	6.5	6.5	6.5	6.5	6.5	6.5	6.5	6.5	6.5	6.5	1Q 1991	Actual
Forecast	1991 4Q	6.7	6.9	6.7	7.0	6.8	6.8	6.8	6.8	6.8	6.9	6.8	4Q 1991	Forecast
	1992 4Q	5.9	6.5	6.3	6.7	6.4	6.6	6.5	6.4	6.3	6.5	6.5	4Q 1992	
	1993 2Q	5.9		6.1			6.6	6.0	6.1	6.1	6.3	6.5	2Q 1993	



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